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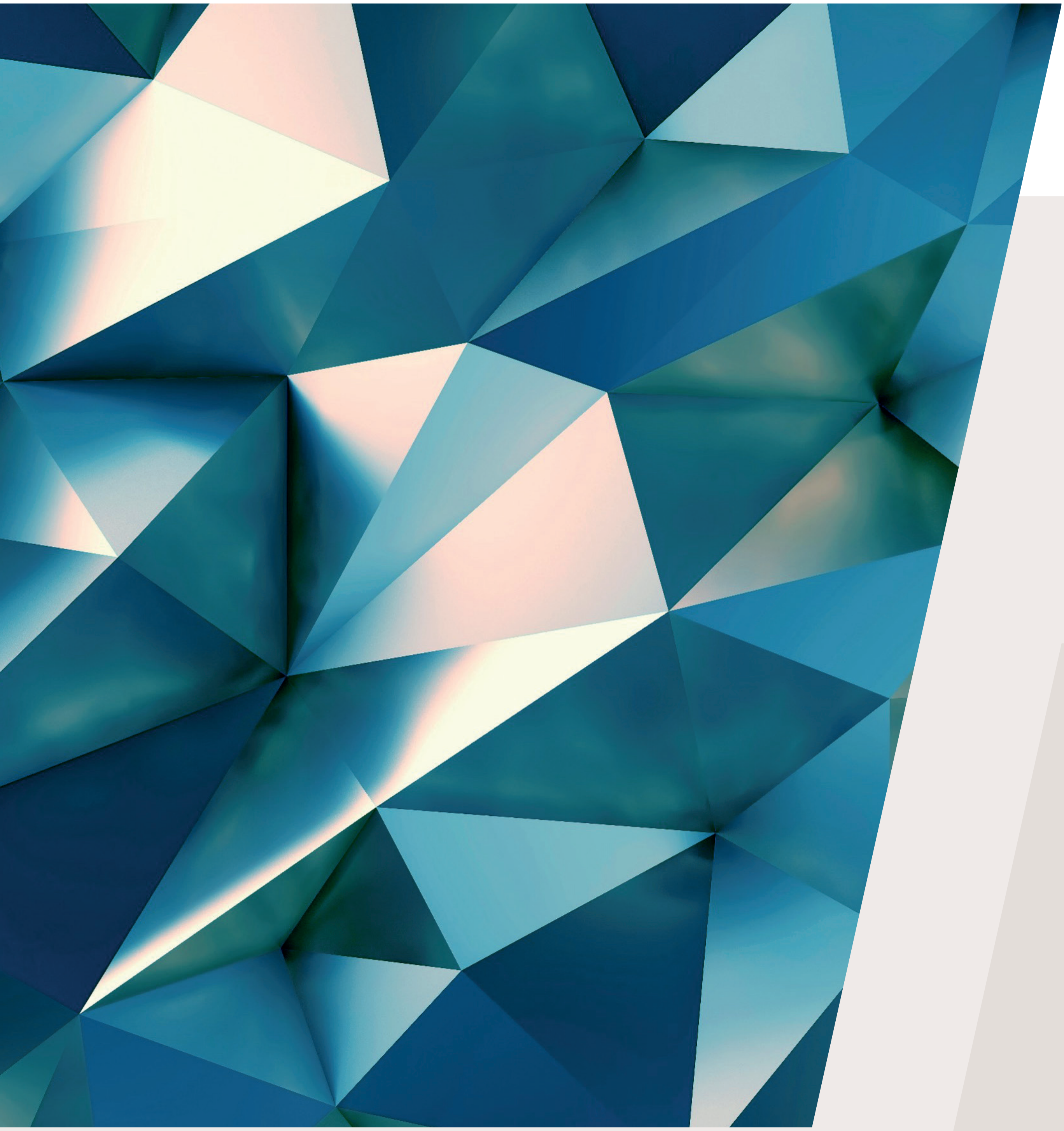

MARCH 2023

Mosaique Asset Allocation

Our current view

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KEY TAKEAWAYS

- Inflation is slowly rolling over, and interest rates are approaching cyclical peaks;
- Growth risks continue to moderate;
- Tactical headwinds for portfolios are fading as a result.

The cyclical risks markets had to deal with in 2022 continue to fade, even as geopolitical risks (Ukraine, and heightened China-US tension) remain elevated.

Most importantly, inflation risk seems to have peaked – and with it, interest rate risk. Headline inflation has slowed on both sides of the Atlantic, and in Europe especially a deepening slump in the wholesale cost of natural gas suggests that this trend will gather momentum during the year.

Underlying inflation rates look more stubborn, and have yet to peak definitively in Europe, but wages – labour unrest notwithstanding – are still not accelerating as they might have done. As a result, underlying inflation also seems likely to gradually subside later in the year.

Meanwhile, the policy rates now priced into money markets for this spring are firmly back in what we used to think of as "normal" territory (though central bank balance sheets aren't yet), and have nudged higher again in the last month as central banks and markets assess the likely peaks. Growth in aggregate demand has moderated, and supply constraints have also eased somewhat.

The slowing in growth remains less dramatic than feared. Technical recession is still possible in 2023, but there are few signs yet of that, let alone the more pronounced downturn that has been so widely predicted for so long. We continue to think that a severe downturn is neither necessary nor likely.

The big objective threats to growth in the last year have been the worsened terms of trade for developed economies that resulted from surging commodity costs, and the impact of that belated normalisation of nominal interest rates. China's zero-covid policy was also a significant restraint for much of the time.

Two of these threats have faded further in the last month. Those slumping natural gas prices in Europe have cancelled and partially reversed the terms of trade hit; China has now abandoned most covid controls. Higher interest rates have yet to make themselves fully felt, but real rates are not high, and the normalisation of nominal rates may not be that potent.

Meanwhile, market valuations have been looking reasonable – even, of late, those for bonds. Stocks were not outlandishly expensive to begin with, and recent cyclically-adjusted valuations have been in line with long-term trends. Bonds were egregiously expensive in 2020, but yields have now risen a long way, and in the last month the big European government markets have been approaching levels that look likely to us to offer attractive returns (though the US market continues to look better value). They no longer seem to be offering "return-free risk".

INVESTMENT CONCLUSION

We are still not out of the cyclical woods. Now, expected interest rates more closely resemble the "plateau"-like profile we have in mind as early rate cuts have been pushed back – but there may still be a little further to travel. We cancelled our long-standing underweight in bonds in USD portfolios some months back, but have not yet felt able to do so in European portfolios.

Meanwhile, expectations for corporate profits in 2023 now look more realistic, but analyst upgrades are likely some way off, and we still think it is too soon to add significantly to overall equity holdings – which would restore them to an overweight position – also.

At end-January we changed the disposition of our equity weightings, away from defensiveness and towards regional and sectoral cyclicality. For the time being, we think this modest increase in portfolio risk is enough.

We currently have relatively few active positions, by the standards of the last few years. But as we stand on the brink of a new cycle, and the potential new leadership it could bring, this seems appropriate.

Asset allocation overview

In early 2022 we reduced our equity positions to neutral, in two stages, taking our liquidity holdings to overweight, and staying double underweight in bonds. Later in the year, we used some of the liquidity to reduce the bond underweight, and in US portfolios eventually closed it completely.

As interest rates approach a peak, and global business surveys seem to be bottoming out, we stay neutral on stocks but at end-January tilted more towards cyclical exposure, and away from defensiveness. We also further adjusted US fixed income positions to reflect what we have seen as improved relative valuations for Treasuries.

Fixed income. European bond yields are still not quite back to levels that we think offer long-term inflation-beating returns, and the ECB seems furthest away from peak policy rates. We stay underweight fixed income and duration in European portfolios, with an ongoing preference for the speculative grade (high yield) segment.

In US portfolios, we are neutral on both the asset class and duration, and most recently on credit quality too, having closed a long-standing underweight on the highest quality bonds at end-January.

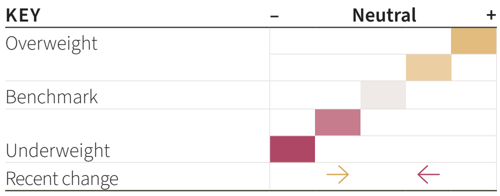
Equities. At end-January we also closed a long-standing overweight in the US, and an underweight in continental Europe (ex Switzerland). Europe is the better play on a stabilising global economy, and the relative lack of "growth" stocks may not matter so much in the next cycle. Being neutral on the two big regions we think leaves us well placed to watch the evolving tussle for leadership.

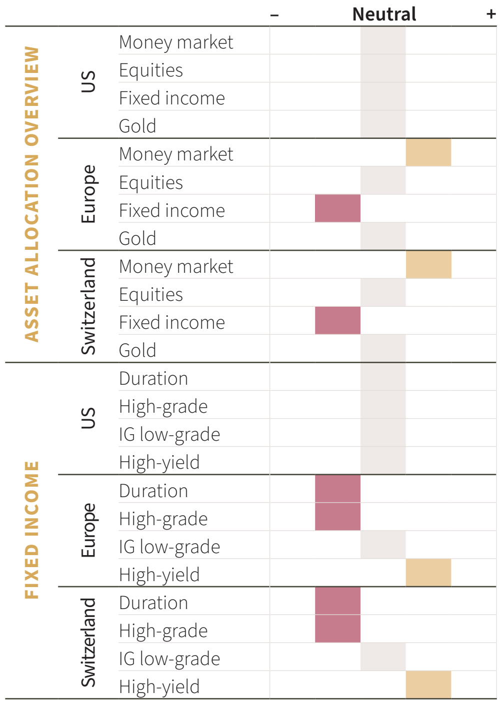
We also re-established an overweight position in emerging Asia – somewhat chastened, as we had closed the position relatively recently, at lower market levels. But the facts had changed: China's cyclical outlook improved materially with the unexpected abandonment of its zero-covid stance, and has further improved in the last month. Meanwhile, the government has also unexpectedly been more tolerant of previously penalised sectors. The counterpart was a renewed underweight position in the defensive Swiss market.

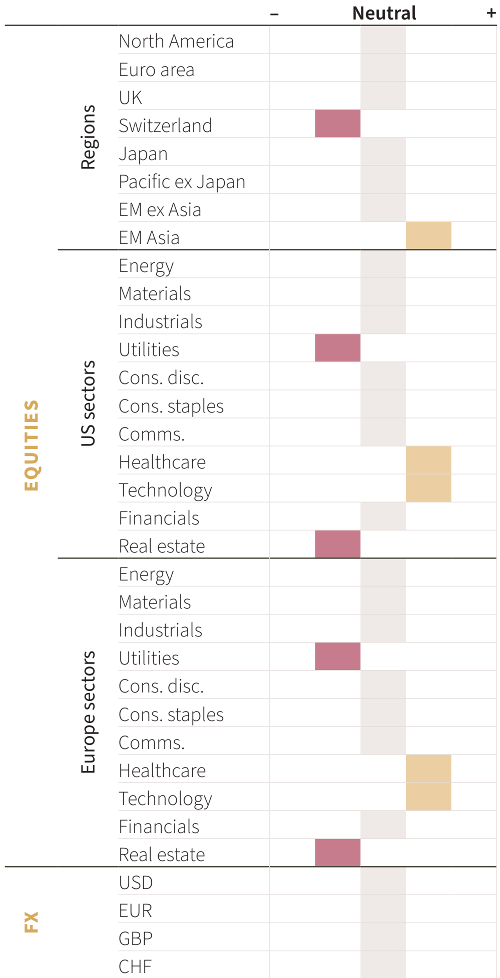
In European portfolios, we also closed an underweight in financials a month ago, and reduced an overweight in (defensive) healthcare. Our sector views in Europe and the US have since been fully aligned.

Currencies. Notwithstanding its modest bounce appreciation in the last month, we think the dollar's underpinnings are less robust of late. The Fed is almost done, and the global economy and risk appetite may be stabilising – arguments for dollar weakness. The US currency also looks expensive. Currency conviction should be low, but we see a stronger euro as part of the possible return from that regional shift in equity holdings.

Asset allocation







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